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In The

Supreme Court of the United States

October Term, 1997

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION,
Successor by Merger to Bank of America Illinois,

Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF OF THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. Whether the "new value exception" to the "absolute priority rule" survived the codification of a modified absolute priority rule under § 1129(b)(2)(B)(ii) of the Bankruptcy Code.

2. Assuming, arguendo, the existence of a "new value exception" as articulated by this Court in *dicta* in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), whether the Seventh Circuit properly applied the exception.

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BRIEF AMICUS CURIAE FOR AMERICAN COLLEGE OF REAL ESTATE LAWYERS IN SUPPORT OF THE PETITIONER

This brief is filed on behalf of the American College of Real Estate Lawyers as *amicus curiae*, in support of the Petitioner.[1]

STATEMENT OF INTEREST OF AMICUS CURIAE[2]

The American College of Real Estate Lawyers ("ACREL") is a nonprofit corporation, organized for the purpose of, inter alia, gathering together lawyers "to improve and reform real estate law and practice," (ACREL Articles of Incorporation at 2). ACREL's membership consists of over 800 attorneys from nearly every state and the District of Columbia who have concentrated their practice in real estate law for a period of ten years or more and law school professors specializing in the field of real estate law. In addition, members elected to ACREL must have demonstrated a willingness to devote time to improving real property law through writing, teaching or participation in professional association activities. ACREL's membership represents the entire spectrum of the real estate industry including borrowers,

[1] Counsel for a party did not author this brief in whole or in part. No person or entity, other than the Amicus Curiae, its members, or its counsel made a monetary contribution to the preparation and submission of this brief.

[2] Consent letters have been obtained from counsel for the parties, copies of which accompany this brief.

lenders, investors and developers. The case at bar involves a debtor whose single asset is an interest in commercial real estate that has declined in value to a point where the debtor's real estate is worth less than the amount of secured debt on the property. Whether the property securing the debt may be retained by the debtor's partners under a new value plan without paying the debt is an issue of significant concern to the real estate industry.

This brief supports the brief of the Petitioner in this case. Due to the background of the Amicus, its experience as counsel to lenders and borrowers, and its familiarity with the confusion, costs and consequences to the real estate industry arising from the ambiguities created by the issues before this Court, ACREL is in a unique position to offer its expertise concerning the adverse consequences of an affirmance of the decision below on the availability of financing for the acquisition, development, and financing of commercial real property in the United States.

SUMMARY OF ARGUMENT

This brief urges that the Seventh Circuit be reversed for the following reasons:

1. There is no new value exception or corollary to the fair and equitable requirement of the Bankruptcy Code. The new value principle as articulated in *dicta* prior to the adoption of the Bankruptcy Code was rejected by Congress in favor of a more flexible and

modified absolute priority rule that obviated the need for a new value principle.

2. The new value exception applied by the Seventh Circuit distorts the new value corollary articulated by this Court in its *Case v. Los Angeles Lumber* and represents a post-Code invention that contravenes the parameters set by Justice Douglas in *Case* and threatens the very existence of the absolute priority rule.

3. The Seventh Circuit's decision undermines the protection for real estate mortgages built into the Bankruptcy Code and threatens to have a severe negative impact on the real estate industry and the availability of real estate mortgage financing.

ARGUMENT

I. THE SO-CALLED NEW VALUE EXCEPTION OR NEW VALUE COROLLARY DID NOT SURVIVE THE ADOPTION OF THE BANKRUPTCY CODE.

This brief supports the conclusions and reasoning of the brief of the Petitioner, the dissent of Judge Kanne in the Seventh Circuit's opinion in *In re 203 N. LaSalle Street Partnership*, 126 F.3d 955, 970 (7th Cir. 1997), and the opinion of the Second Circuit in *Coltex Loop Central Three Partners, L.P., v. BT/SAP Pool C Associates, L.P. (In re Coltex Loop Central Three Partners, L.P.)*, 138 F.3d 39 (2d Cir. 1998), that there is no holdover new value exception or corollary to the absolute priority rule of the Bankruptcy Code.

A. Confirmation of New Value Plans Prior to the Adoption of the Bankruptcy Code is an Illusion.

The Seventh Circuit stated that "the new value corollary has long been ensconced in our bankruptcy practice," 126 F.3d at 965, and that it has been "a major source of new funding in reorganizations for the past fifty years." *Id.* at 966. From this predicate, the Seventh Circuit concluded that "one would expect that Congress would address deliberately such a significant issue of economic policy if it had determined to abolish it." *Id.* The problem with this conclusion is that its predicate is incorrect.

From the decision of this Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), to the adoption of the Bankruptcy Code in 1978, there appears to be no published evidence that any "shareholder was ever able to convince a court that she contributed sufficient value to be able to retain an interest. Indeed, until the Code's adoption in 1978, no reported case seems to have adopted Justice Douglas' *dicta* as its holding." Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 92 (1991). See also John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 Mich. L. Rev. 963, 1016 (1989), where Professor Ayer concludes, "Justice Douglas' supposed 'exception,' . . . is nowhere present as a rule of decision in Chapter X cases. New value under Chapter X, then, is an illusion."

Thus, there was no 50 year history of the new value exception being part of bankruptcy "practice." While the new value theory, as expressed in *dicta* by this Court in

Case, was known, the purported employment of that theory never became part of bankruptcy "practice" until *after* the adoption of the Bankruptcy Code.

B. Congress Rejected the New Value Exception When It Drafted the Bankruptcy Code.

In 1973, the Commission on the Bankruptcy Laws of the United States in its Report, concluded that under the absolute priority rule, debt and equity security holders are "frequently eliminated from participation in a reorganization by reason of the strict application of a statute designed primarily for their protection." H.R. Doc. No. 93-137, pt. 1, at 256 (1973). The absolute priority rule did not permit old equity to participate even with the agreement of all classes of creditors. The Commission's solution was to modify the absolute priority rule by permitting juniors to participate on the basis of a contribution "important to the operation of the reorganized debtor . . . under the plan" on a basis reasonably approximating the value of their contribution. H.R. Doc. No. 93-137, pt. 2, at 242. This proposal created a storm of criticism, *see, e.g.*, Victor Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 Am. Bankr. L.J. 305, 337 (1974); Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651, 669-70 (1974); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 Harv. L. Rev. 1786, 1817 (1974), and was rejected by Congress.

In its place, Congress modified the absolute priority rule to limit its application to dissenting impaired classes

of creditors only,[3] thus freeing classes of creditors to admit junior interests by agreement. If this limited absolute priority had been in effect under the Bankruptcy Act, the *Case* plan would have been confirmed[4] and the issue that produced the new value *dicta* would never have arisen. Thus the Bankruptcy Code obviated the need for a new value corollary. Recognizing such a modification of the absolute priority rule, the dissent in *LaSalle* noted, "the pre-Code rationale for the new value exception makes little sense in today's Chapter 11 environment." 126 F.3d at 976. Congress considered a provision that would have incorporated new value into the Code (even including, it would seem, alternative forms of contribution, such as were proffered in *Case*), rejected it, and

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[3] Under the Bankruptcy Act, "Congress ha[d] required both that the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable'. The former [was] not a substitute for the latter. . . . Accordingly the fact that the vast majority of the security holders ha[d] approved [a] plan [was] not the test of whether the plan [was] a fair and equitable one." *Case*, 308 U.S. at 114 (interpreting § 77B of the Bankruptcy Act, superseded by Chapter X). *Compare* Bankruptcy Code § 1129(b)(1) (applying the fair and equitable requirement only to dissenting, impaired classes).

[4] Though the *Case* plan had been approved by all classes of creditors, one individual creditor objected. The objecting creditor held an obligation with a face amount of $18,500, as compared to almost four million dollars in bonds outstanding. The objecting creditor's class approved the plan, and had the Bankruptcy Code been in effect, the plan would have been confirmed without employing the cramdown provision of § 1129(b).

enacted the compromise that allowed for participation by agreement.

The Seventh Circuit opined that Congress incorporated the new value exception when it drafted the Bankruptcy Code because, "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate.' " 126 F.3d at 965 (quoting *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992)). The facts, however, indicate either that new value was not on Congress's slate when the Bankruptcy Code was being considered, or that Congress had erased new value from whatever was on its slate before it began to write.

C. The Language of the Bankruptcy Code Precludes the Confirmation of New Value Plans.

The clear language of Bankruptcy Code § 1129(b)(2)(B) provides that a plan is not fair and equitable as to a dissenting impaired class of creditors if a junior interest, such as old equity,[5] retains an interest on account of its junior interest in the debtor. Yet the Seventh Circuit, in *LaSalle*, permits such a result.

The Seventh Circuit maintains that old equity's interest is not being retained "on account of" its former interest, but rather because the debtor's partners have made a bid for the enterprise, as a third party might, in the form of new value. 126 F.3d at 964. It stretches credulity to believe that old equity, in control of all the information about the property and with the *exclusive right* to retain

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[5] The term "old equity" as used herein refers to the stockholders, partners, or principals of the debtor.

an interest through a new value contribution under the plan, is not retaining an interest "on account of" its junior interest. Indeed, in *LaSalle* the Bankruptcy Court virtually admitted the motivation for the debtor's plan was based on old equity's junior interest in the partnership. It stated that the plan was submitted for the purpose of protecting the partners from tax losses arising out of their partnership interest in the debtor. *See In re 203 N. LaSalle Street Partnership*, 190 B.R. 567, 588 (Bankr. N.D. Ill. 1995) ("The debtor's partners thus seek to *retain their interests* not because of the intrinsic value of these interests, but because of the tax consequences that flow from their loss.") (emphasis added).[6]

Additionally, the language of the Bankruptcy Code precludes confirmation of new value plans in another way. Consistent with the decisions of this Court acknowledging that a secured creditor's property right in the collateral must be protected up to the value of the collateral, *see Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278 (1940) (where Justice Douglas stated that the Fifth Amendment required that safeguards "protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property"), Congress provided in § 1129(b)(2)(A)(i) that the secured claim be equal in amount and value to the value of the collateral as of the

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[6] The Seventh Circuit did not disturb the Bankruptcy Court's finding that the plan was being submitted on account of the tax liabilities arising from the partners interest in the debtor. In connection with the bank's claim that the tax motivation evidenced lack of good faith, the Seventh Circuit stated that "the desire to avoid significant tax liabilities, if legal, is a result consistent with the Bankruptcy Code." 126 F.3d at 969.

effective date of the plan. If old equity's new value contribution constitutes a bid for the property, it is a bid in excess of what was previously believed to be the value of the property. Section 1129(b)(2)(A) requires that the secured claim be equal to the value of the collateral and thus the secured claim must be increased to the higher value. As a result, at least in single asset situations, unless the senior secured class votes to include a participation by old equity, or, as suggested in *Coltex*, the property is auctioned off to the highest bidder, *see* 138 F.3d at 44-45, the language of the Bankruptcy Code would preclude confirmation of a plan, such as that proposed in *LaSalle*, under which the property is to be acquired by old equity over the objection of the secured creditor for less than the full amount of the mortgage balance.[7]

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[7] In *LaSalle*, the Bankruptcy Court attempted to deflect this argument by finding that the bid was not based on the "intrinsic" value of the real estate "but because of the tax consequences that flow from their loss." 190 B.R. at 588. However the price paid for property is normally considered determinative of value without an examination of the motivations of the purchaser. "[I]f the collateral is actually sold during the course of the bankruptcy proceedings or pursuant to a confirmed plan, the consideration received from the sale will almost always resolve the question of value." 5 COLLIER ON BANKRUPTCY ¶ 506.03[4][a] at n.58 (Lawrence P. King et al. eds. 15th ed. rev.1997). Indeed, in *LaSalle*, the bankruptcy court itself, in referring to what would be paid on the deficiency claim, stated that the creditor will receive "50% of the net *value* of the property either as *realized in a sale*, or as appraised at the time of any refinancing." 190 B.R. at 576 (emphasis added). The price paid indicates value. The motivation of the purchaser is irrelevant. If the purchaser's motivation for buying were a consideration in determining value, every purchase price could be attacked as not representing the value of the property since

It is thus clear from the language of the Bankruptcy Code and the intent of Congress that under the Bankruptcy Code, a plan granting an interest to old equity cannot be imposed on a dissenting, impaired class of creditors that has not been afforded absolute priority, whether or not new value is contributed.

II. THE NEW VALUE EXCEPTION AS ADOPTED BY THE SEVENTH CIRCUIT DISTORTS THE NEW VALUE COROLLARY AS ARTICULATED IN *DICTA* BY THIS COURT AND MOLDS IT INTO AN EXCEPTION THAT WOULD EFFECTIVELY ABROGATE THE ABSOLUTE PRIORITY REQUIREMENTS OF THE BANKRUPTCY CODE.

As discussed above, this brief argues that no new value principle survived the adoption of the Bankruptcy Code. Even if this Court should conclude that new value is still viable, the Seventh Circuit should be reversed because the supposed "new value corollary" applied by the Seventh Circuit is not the corollary to absolute priority articulated by this Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

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each purchaser brings its own baggage to the bidding table, whether it be the purchaser's tax or financial situation, architectural preferences, availability of funds for investment, or individual preferences. Valuation based on motivation would be an invitation to manipulation and litigation.

A. The Seventh Circuit Ignores the Creditor Protection Prong of this Court's Articulation of the New Value Requirements.

In *Case*, this Court struck down a plan under which old equity attempted to circumvent the requirement that a plan had to be "fair and equitable," which term requires that interests in the debtor be distributed on the basis of "absolute priority." 308 U.S. at 115-17. The *Case* plan, approved by all classes of creditors, would have allowed old equity to retain an interest in the debtor based on a promised contribution of expertise even though creditors were not fully compensated.[8]

This Court noted that it had previously stated that creditors could be protected "through other arrangements, *which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor . . .*" 308 U.S. at 117 (quoting *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445, 454 (1926)) (emphasis added). Justice Douglas stated that where the *necessity* for funds exists and old equity makes a fresh contribution "and receive[s] in return a participation *reasonably equivalent* to their contribution," the creditors cannot object on the ground that they were not accorded their "full right of priority against the corporate assets." *Id.* (emphasis added).

The *dicta* in *Case* permitted old equity to participate only if certain conditions were met. Foremost among those conditions was that the creditors' "full right of

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[8] *Case* was decided under § 77B of the Bankruptcy Act of 1898 (48 Stat. 912).

priority" against the debtor's assets be preserved.[9] 308 U.S. at 122. Old equity could not participate "at the expense of the prior rights . . . of creditors." *Id.* at 116. It is this creditor protection prong of the *Case dicta* that the Seventh Circuit, and cases adhering to its view, ignore. In *LaSalle*, old equity was allowed to retain valuable property at the expense of the unpaid mortgagee, which received only 16% on its deficiency claim. This would

[9] This principle was articulated in many ways in the language of the decision. For example: (i) Justice Douglas, quoting the decision in *Louisville Trust Co. v. Louisville, N.A.&C. Railroad Co.*, 174 U.S. 674, 684 (1899), stated that "any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation." 308 U.S. at 116; (ii) *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482, 508 (1913) was quoted as support for the proposition that "value, whether it was present or prospective, for dividends or only for purposes of control. . . . was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever." *Id.*; (iii) Justice Douglas quotes *Kansas City Terminal Railway Co. v. Central Union Trust Co.*, 271 U.S. 445, 455 (1926), for the proposition that "to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation," 308 U.S. at 120, and concludes that the proposed plan did not "recognize the 'equitable right' of the bondholders to be preferred to stockholders against the full value of all property belonging to the debtor corporation . . . since the full value of that property is not first applied to claims of the bondholders before the stockholders are allowed to participate" *Id.*; and quoting *Kansas City Terminal* again, Justice Douglas stated that when "assessments are demanded, they must be adjusted with the purpose of according to the creditor his full right of priority against the corporate assets, so far as possible in the existing circumstances." 308 U.S. at 121.

hardly seem to accord the creditor its "full right of priority."[10]

Thus, by not affording the creditor its full right of priority, the *LaSalle* debtor's plan did not meet this requirement of the new value corollary to the absolute priority rule, was not fair and equitable, and should not have been confirmed over the objection of an impaired class of creditors.

[10] How the standards of the *Case* dicta can be achieved has been the source of much controversy. Professors Ayer and Markell apparently believe that the requirements of the *Case dicta* can never be achieved. *See* Ayer, *supra*, at 1016; Markell, *supra*, at 92-93. However other theories have been articulated that would seem to achieve in large measure the balance Justice Douglas was looking for. For example, it has been suggested that the interest of the new value contributor be determined based on a sharing of the equity. Under this theory, the enterprise value prior to the infusion of new value remains with the creditors. The interest of old equity will be determined by comparing the capital infusion to the value of the enterprise after the infusion. Since this theory does not deal with the issue of how control would be valued (especially significant in an enterprise with little or no value) an alternative theory, based on the proposition that the entire value of the enterprise, including control, belongs to the unpaid creditors and thus the interest of old equity should be measured by comparison to the amount of unpaid debt. These theories are discussed in greater detail in Robert M. Zinman, *New Value and the Commission: How Bizarre!*, 5 Am. Bankr. Inst. L. Rev. 477, 487-90 (1997). No attempt at meeting the "full right of priority" prong of Justice Douglas' *dicta* was even attempted in *LaSalle*.

B. The Seventh Circuit Distorts the Other Prerequisites to New Value Articulated by this Court in *Case*.

As discussed above, under the *dicta* in *Case*, a plan in which old equity retains an interest might be confirmed upon a contribution of new value in the form of money or money's worth *only if* the full priority rights of creditors are preserved. In order to preserve those priority rights, Justice Douglas stated that certain prerequisites must be met. First, the new value must be necessary or " *'essential to the success of the undertaking'*," 308 U.S. at 121 (quoting *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445, 455 (1926)) (emphasis added); and second, the contribution must be "reasonably equivalent in view of all the circumstances to the participation of the stockholder." 308 U.S. at 122. In *LaSalle*, the requirements of necessity and reasonable equivalence have been so distorted that in reality they no longer are prerequisites to confirmation of a new value plan. In large measure, they have been dissolved in a new amorphous requirement of substantiality that seems to have no objective standards to determine if it has been met.

1. The Seventh Circuit distorts the requirement that the contribution be essential to the success of the undertaking.

When Justice Douglas referred to the "necessity, at times, of seeking new money 'essential to the success of the undertaking'," 308 U.S. at 121 (quoting 271 U.S. at 455), he was referring to the necessity for funds to continue the operation of the enterprise, the production of its

product, the provision of its services, and the employment of its workers. In single asset real estate cases, such as *LaSalle*, it is difficult to find this necessity. There is no business to be continued, no product to be produced, and no service to be performed that will not be continued, produced, or performed by the new owner of the real estate.

Confronted with the fact that funds were not essential to the success of the undertaking in *LaSalle*, the Seventh Circuit distorted the necessity requirement to mean essential for confirmation of the debtor's plan! ("The infusion of new capital was necessary for the successful implementation of the plan." 126 F.3d at 967). Since new value is always proposed by the debtor to enable old equity to keep the property under the plan, this switch in the meaning of "necessary" would result in virtually every new value plan meeting the necessity requirement. In effect the Seventh Circuit is saying that the debtor may wipe out the creditors' interests if that is the only way old equity can retain the property while leaving the debtor's debts unpaid. This effectively reads "essential to the success of the enterprise" out of the prerequisites for new value plan confirmation.

2. Reasonable equivalence is eliminated in no-equity situations.

Under the prerequisite of reasonable equivalence, old equity may not receive more than the reasonable equivalence of its contribution. In single asset cases, the debtor usually has no equity in the property (the property value is equal to or lower than the mortgages encumbering it),

as was the case in *LaSalle* where the asset was valued at $54.5 million but was encumbered by Bank of America's mortgage of $93 million, leaving a deficiency claim of $38.5 million, 84% of which was wiped out under the debtor's new value plan. In the past, debtors have argued that retention of the property by old equity does not deprive the creditor of its full right of priority because what the debtor proposes to retain is worthless. This Court has clearly rejected this "no-value" argument. In *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482, 508 (1913), this Court stated that "control" itself was an asset that constituted value and that such value belonged to the creditors, not old equity. This Court again, in 1988, reaffirmed that determination in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), stating that "we join with the consensus of authority which has rejected this 'no value' theory." *Id.* at 207.

The *LaSalle* bankruptcy court seemed to have no difficulty in ignoring these decisions when it employed the no-value theory as the basis for determining that the contribution met the reasonable equivalence standard. The Bankruptcy Court stated that "the contribution is easily the equivalent of the interests retained by the debtor's partners. Indeed, on the market, those interests are worthless." 190 B.R. at 588. The Seventh Circuit merely acknowledged that the Bankruptcy Court had determined that the contribution was "reasonably equivalent to the interest retained" and failed to discuss how or on what basis the requirement had been met, apparently agreeing with the Bankruptcy Court's approach. *See* 126 F.3d at 967.

LaSalle, then, reads the "reasonably equivalent" prerequisite out as a condition to new value plan confirmation, at least in those cases where the debtor has no equity in the property.

3. The new requirement of substantiality serves as a smoke screen for the failure to follow the *Case* prerequisites.

When the new value principle was rediscovered and revised after the adoption of the Bankruptcy Code, a new prerequisite was added by the courts, which required that the contribution be substantial. The Seventh Circuit referred to this requirement as a corollary of the requirement of necessity. *See In re Snyder*, 967 F.2d 1126, 1131 (7th Cir. 1992). Other decisions of the Seventh Circuit have seen the substantiality requirement as a summary of all other factors, which means that if the contribution is substantial, it meets at least the necessity and reasonable equivalence requirements. This "substitute" theory is articulated in the bankruptcy court decision in *LaSalle*, where the court understood the decision in *In re Woodbrook Associates*, 19 F.3d 312, 320 (7th Cir. 1994), to imply that "substantiality serves as something of a summary of the other factors." 190 B.R. at 587. This conclusion is obviously a non-sequitur of major proportions. While a nominal contribution might be an indication that the contribution is not necessary for the success of the enterprise, it does not follow that a large contribution is necessary. As for reasonable equivalence, one cannot consider whether a contribution of any size is reasonably equivalent in the abstract; one must first determine the value of

the interest to which the contribution is supposed to be reasonably equivalent.

The unique aspect of the substantiality requirement is that there appear to be no standards to determine whether it has been met. The Seventh Circuit in *LaSalle* quotes other decisions in that Circuit stating that the contribution cannot be "merely nominal, or gratuitous." 126 F.3d at 967 (citations omitted). Beyond that, " '[w]hether the infusion of new capital is 'substantial' is more a common sense determination than a mathematical calculation when the debtor comprises only a single real estate asset which is fully encumbered.' " *Id.* (quoting *Woodbrook*, 19 F.3d at 320). This common sense determination is made by looking to whether the contribution is "real and necessary to the successful implementation of the *plan*." *Id.* (emphasis added). The Seventh Circuit approved the Bankruptcy Court's determination that the amount was substantial in both absolute terms, *see* 126 F.3d at 967 (comparing contribution with dollar amounts approved in other cases), and its impact on the case. *See id.* (measuring the contribution as a percentage of the unsecured debt in this case as compared to others).

The circularity of the Seventh Circuit's discussion of substantiality begins with reading into the Bankruptcy Code the pre-Code *dicta* of this Court, strictly limited by prerequisites. The next step is to incorporate a *new* prerequisite of substantiality and determine that it serves as a summary of the prerequisites in the pre-Code *dicta*, thus permitting the court to ignore or give scant attention to them. Then the court determines that whether substantiality is met is a subjective determination with virtually no objective standards. The result appears to be that only

the words "new value" survived the adoption of the Bankruptcy Code but not the standards by which the new value corollary would be met.

- By ignoring the creditor priority prong of this court's new value *dicta*, and then distorting both the necessity and reasonable equivalence prerequisites and subordinating them to a new amorphous requirement of substantiality, the Seventh Circuit has converted the *Case corollary* to a wide *exception* to the absolute priority rule that threatens to consume the rule itself. We respectfully urge that the Seventh Circuit be reversed.

III. THE APPLICATION OF THE SEVENTH CIRCUIT'S VERSION OF NEW VALUE TO SINGLE ASSET REAL ESTATE REORGANIZATIONS WOULD SERVE NO PUBLIC PURPOSE, ABROGATE THE PROTECTION FOR MORTGAGEES BUILT INTO THE BANKRUPTCY CODE, AND HAVE A SEVERE NEGATIVE IMPACT ON BORROWERS, LENDERS AND THE REAL ESTATE INDUSTRY.

A. No Public Purpose.

The confirmation of new value plans is often urged as a matter of public policy on the ground that the funds are needed to keep the debtor in business, preserve the going concern value, keep people employed, and preserve the performance or production of needed services or products. Whether or not such arguments make sense in the case of a manufacturer or service provider, these laudable objectives are wholly inapplicable to single asset real estate cases. In the single asset real estate transaction the operation of the real estate will continue no matter

who is the owner of the property. It is inappropriate to say that the "reorganization will fail" if there is no infusion of new value. The only thing that may fail is the attempt by old equity to keep the debtor's property without paying its just debts.[11]

If the debtor's plan cannot be confirmed and the property goes to foreclosure, the mortgagee or other purchaser at the sale will operate the property. The question is not whether the business will continue; the question is only who will own the property – the debtor's old equity who have not paid the debtor's obligations to creditors, or the creditors who have not been paid. The decision below opts for the former, with old equity given the property and 84% of the creditor's deficiency claim wiped out. No public purpose can be served by such a result.

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[11] The Seventh Circuit does not appear to recognize the distinction between a corporate entity that is an active business and a single asset real estate partnership, which does not have an active business but is primarily a vehicle for owning real estate. In concluding that new value survived the adoption of the Bankruptcy Code, the court states that to conclude otherwise would assume that Congress, without addressing the issue, made a decision "affecting the economic health, and indeed the continued existence, of many *corporate entities*." 126 F.3d at 966 (emphasis added). While there are, of course, some corporations that are single asset entities, the purpose of the court's example is to describe the effect of bankruptcy on going businesses, seemingly without appreciation of the fact that most single asset entities are partnerships like LaSalle, without a going business to be concerned about.

B. Abrogation of Mortgagee Protection.

Section 1129(b)(2)(B)(ii) of the Bankruptcy Code prohibits confirmation of a plan over the objection of an impaired class of unsecured creditors if old equity is permitted to retain an interest in the property on account of its junior interest. A major reason for this provision was to overcome the so-called *Pine Gate* line of cases that treated nonrecourse mortgagees as the Seventh Circuit now treats all mortgagees. In *In re Pine Gate Associates, Ltd.*, 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976), and its progeny, decided under chapter XII of the former Bankruptcy Act, the bankruptcy courts allowed debtors to retain the mortgaged property upon payment to the non-recourse mortgagee of the depressed (due to the mid-70's recession) value of the collateral.[12] In direct response to the perceived inequity of the *Pine Gate* line of cases, Congress was asked to restore absolute priority to real estate arrangements under the new chapter 11 of the Bankruptcy Code. *See, e.g., Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in the Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong. 853, 855-56, 864-76 (1977) (statement of John J. Creedon, American Council of Life Insurance).

Congress enacted a package of protection insuring that the mortgagee may have an unsecured claim for the deficiency, see 11 U.S.C. § 506(a), and providing absolute

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[12] In *State Mutual Assurance Co. of America v. KRO Associates (In re KRO Associates)*, 4 Bankr. Ct. Dec. (CRR) 462, 463, 470 (Bankr. S.D.N.Y. 1978), there were approximately $14 million in mortgages on the property. The court, using a 20% capitalization rate, found the value of the property to be $895,000.

priority for each dissenting impaired class of creditors, including the unsecured class. *See* 11 U.S.C. § 1129(b)(2). It was this absolute priority for the unsecured class, including the mortgagee's deficiency claim, that provided the protection afforded by Congress. If the unsecured class rejected the plan (and normally in single asset cases the mortgagee's deficiency claim is the only major unsecured claim) the debtor would not be able to retain the property without paying the creditors. Such a plan could not be confirmed.

New value as applied in *LaSalle* and many post enactment Bankruptcy Code cases would abrogate this protection by essentially restoring the *Pine Gate* rule – in a much more sinister form. In both situations the debtor would keep the property. The difference is that under *Pine Gate*, the mortgagee would receive an immediate payment of cash equal to the court determined value of the collateral, whereas in the new value cases after the enactment of the Bankruptcy Code, the mortgagee could receive only a mortgage with a face amount equal to the court determined value of the collateral. This retention of the property by old equity when portions of, or all of, the mortgagee's deficiency claim is wiped out is clearly the opposite of what Congress intended. *See* S. Rep. No. 95-598, at 65 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5851 (stating that a precursor of present § 1111(b), which affords a deficiency claim to nonrecourse mortgagees, "answers the nonrecourse loan problem and gives the creditor an unsecured claim for the difference between the value of the collateral and the debt in response to the decision in" *Pine Gate*); *see also In re DRW Property Co. 82*, 57 B.R. 987, 990 (Bankr. N.D. Tex. 1986) (stating Congress

enacted § 1111(b) "to alleviate the *Pine Gate* problem and to attempt to restore the benefit of the bargain to the nonrecourse secured creditor").

It should be apparent that new value, as interpreted by the Seventh Circuit, would undo the absolute priority protection afforded by Congress to mortgagees. This would represent a major adverse change in the treatment of mortgages in bankruptcy.

C. Negative Impact on the Real Estate Industry.

The decision below will have a severe adverse impact on the real estate industry. Literally billions of dollars have been loaned to real estate developers by institutions, including insurance companies and pension plans that insure and protect millions of ordinary citizens, on the strength of real property collateral and the protection for realization on that collateral built into the Bankruptcy Code. Mortgage loans are securitized, rated and sold to investors seeking the security of the mortgage collateral. These purchasers include individual investors and pension funds, as well as institutions investing policyholders' funds and deposits from individuals and corporations, all of whom make these investments based on the ability to realize the benefit of the bargain if there is a default in the income flow.

The decision below can only result in the severe reduction of the availability of funds for real estate development from institutions and from the public, and tighter credit standards and higher interest rates for those funds that are available or those securities that are sold. *LaSalle* not only threatens existing mortgage debt held by

lenders, but also threatens the future of the real estate and real estate securities industry.

The Bankruptcy Code was carefully drafted by Congress to balance the interests of debtors and creditors and provide for the efficient administration of bankruptcy cases in the United States. If Courts are permitted by judicial legislation to undermine the foundations of the protection afforded to real estate mortgagees, the real estate industry and the national economy, will be severely and adversely affected.

CONCLUSION

For all the reasons set forth herein, the American College of Real Estate Lawyers respectfully urges that the decision of the Seventh Circuit be reversed.

Respectfully submitted,

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